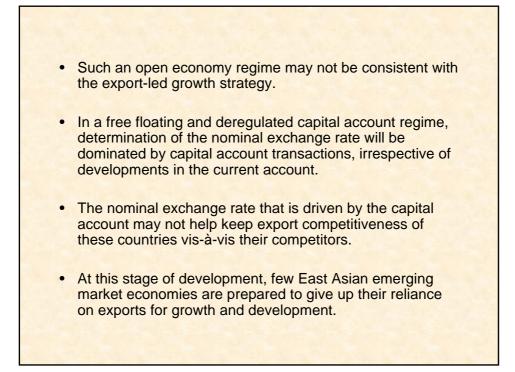


II-2. Conflict between Export-led Growth and Free Floating

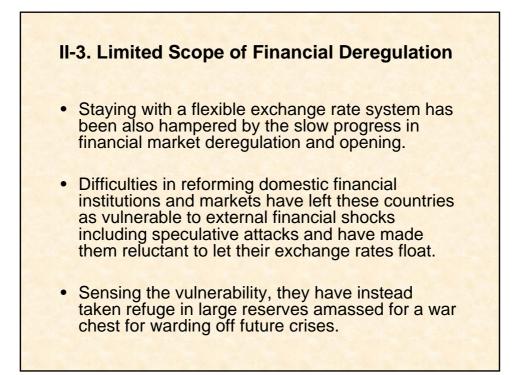
• Immediately after the crisis, the crisis-hit countries except for Malaysia had to embrace a more flexible exchange rate system.

• A greater exchange rate flexibility together with capital account deregulation increased volatility of the nominal exchange rate.

• The volatility increase in turn made it difficult to maintain competitiveness of East Asia and hence to promote the export-led growth strategy.

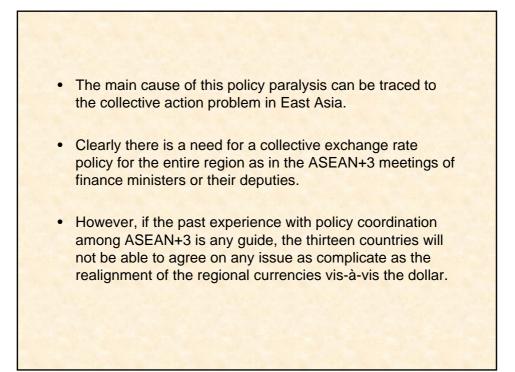


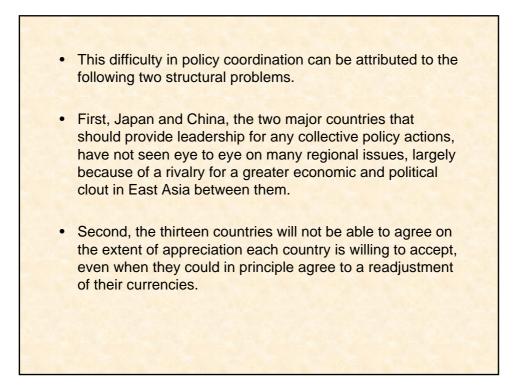




III. Realignment of East Asian Currencies: Collective Action Problem

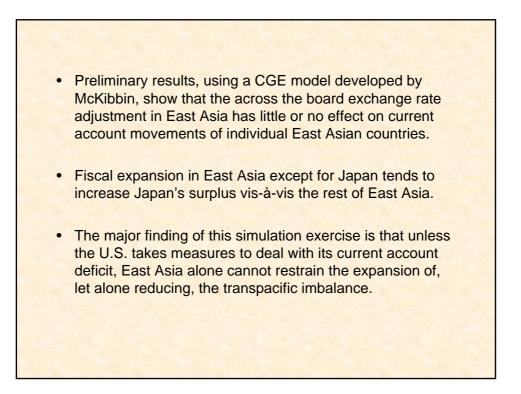
- Now with large amounts of reserves, and the fear of another financial crisis diminished, one would expect that these countries would be inclined to intervene less frequently than before to let their dollar exchange rates appreciate.
- However, East Asian policymakers have not restrained themselves from market intervention.
- As a result, the current policy regime will trigger a painful adjustment which will result in real appreciation of East Asian currencies, possibly igniting a real estate boom, raising inflationary expectations, and eventually curbing further increase in their current account surpluses.





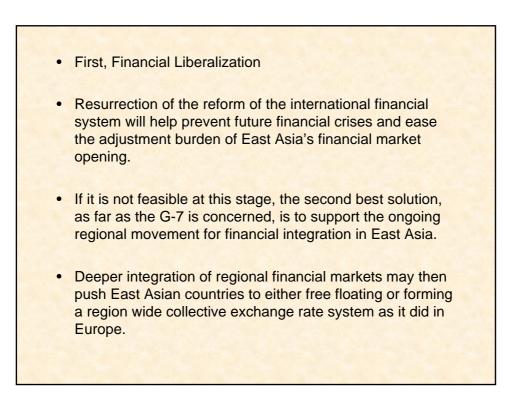
IV. Effects of Policy Adjustments in East Asia on the Transpacific Imbalance

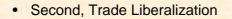
- The demand for an appreciation of all regional currencies in East Asia raises two fundamental questions.
- One is the collective action problem. Another issue is the extent to which an across the broad appreciation of East Asian currencies will reduce the transpacific imbalance.
- This question is an empirical one, and simulation exercises of quantifying the effects of changes in East Asia's policy variables on its surplus suggest that these policy changes will not be very effective (Lee, McKibbin, and Park 2004).



V. A long Term Solution: Trade and Financial Integration in East Asia

- If both the U.S. and East Asia fail to make policy adjustments needed to bring the imbalance under control, what will happen?
- A painful domestic adjustment will eventually run its course to cause real appreciation of East Asia's currencies. This may lead to a bad equilibrium as it did during the 1997-98 crisis.
- What are then long-term solutions to the transpacific imbalance?





- The G-7 countries could also encourage and support in any way they can to help East Asian economies liberalize further their trade regimes.
- Trade integration is then expected to create pressure for stable currencies in the region, which will in turn generate incentives for cooperation for developing a collective exchange rate system for the region. (Bergsten and Park, 2002)

